Agricultural Law Update

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INSIDE

IN FUTURE ISSUES

- Recent developments concerning access to farm labor camps
- New reparation proceedings and arbitration procedures of CFTC
- Mineral owner's tax treatment of oil and gas payments received independent of production
- Legal ramifications of government farm programs

"The mode by which the inevitable comes to pass is effort."

— Oliver Wendell Holmes

Special use valuation: Material participation test

A recent Tax Court case, *Estate of Sherrod,* 82 T.C. No. 40 (1984), has cast additional light on two important issues under special use valuation of farmland — (1) what constitutes material participation and (2) whether cash rented pasture or hay land incidental to a crop share or livestock share lease is eligible for special use valuation.

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Cooperatives — identifying patronage and non-patronage income

Until the summer of 1983, the only court decision dealing with the classification of interest income for cooperatives was *St. Louis Bank for Cooperatives v. United States,* 624 F 2nd 1041 (Ct. Cl. 1980). In the case, the Court of Claims found that certain types of income earned by the Bank for Cooperatives in the course of its operations were patronage sourced. When the *St. Louis Bank* case was decided in 1980, the Internal Revenue Service took the position that it should be narrowly construed and subsequently attempted to reclassify interest earned by cooperatives as non-patronage sourced income in a number of different situations. See *PLR 8204019* (October 20, 1981) and *PLR 8130001* (March 24, 1981). The IRS has now found some support for its hard line position on the classifica-

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Buying farm products from a farmer: Who prevails

The meaning and scope of Section 9-109(3) and 9-307 of the Uniform Commercial Code have been the subject of litigation especially in recent years, and some states have modified the UCC rule. These are the provisions that preclude a purchaser of farm products from a farmer from taking free of a perfected security interest. The artiele in the December, 1983, *Agricultural Law Update* discussed some of the key issues under that UCC subsections.

A 1982 United States District Court ease (In re *Sunriver Farms, Inc.,* 36 U.C.C. 416 (D. Ore. 1982)) involved the rights of a purchaser of farm products in a slightly different fact situation. There, the buyer purchased pinto beans in March. The beans were planted in July. The local lender, a bank, then perfected a security interest in the bean crop. The bank apparently knew of the contract of sale. The court determined that the bank had priority and the purchaser did not take free of the bank's security interest.

A major question for purchasers under forward contracts of farm products is how to protect themselves. One possibility would be for the purchaser to check the record before making payment for the farm products and to refuse to make payment to the seller unless the holders of the perfected security interests that would have priority consent to delivery of the crops in return for a single payment made by the purchaser. A second possibility would be for the purchaser to perfect a security interest in the product when the purchase contract is signed.

— Keith G. Meyer

COOPERATIVES
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tion of interest income in the case of *Twin County Grocers, Inc., v. United States,* decided by the U.S. Court of Claims on June 8, 1983.

The Court determined that the interest income on short-term certificates of deposit purchased out of the cash surplus of the cooperative was not patronage sourced. It distinguished the *St. Louis Bank* case by finding that the purchase of certificates deposited by the Twin County Cooperative was not an integral part of a system by which it obtained necessary funds (in the *St. Louis Bank* case it having been found that the bank dealing with money had a closely related function in investing its funds). In the *Twin County* case the Court found it was a prudent (but incidental) method of enhancing overall profitability for the cooperative to invest its surplus funds and certificates of deposit. This activity was not sufficient, however, to make the interest income on the certificates of deposit patronage sourced.

— *James Dean*

SPECIAL USE VALUATION
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On the material participation issue, two cases decided previously had held against the taxpayer. In *Estate of Coon,* 81, T.C. No. 32 (1983), the farm tenants provided their own machinery and made decisions independently under a crop share lease. The management involvement by a brother of the decedent in overseeing the rental operation was insufficient for material participation. In *Schuneman v. United States,* 84-1 U.S.T.C. ¶ 13,561 (C.D. Ill. 1984), the material participation test was not met where the tenant paid all of the costs of production with the lease not contemplating participation by the tenant in management decisions. Neither the tenant's use of the landowner's storage nor repairs to farm buildings made by the landowner constituted material participation.

In the latest case, *Estate of Sherrod, supra,* the decedent died with 1,478 acres of land in a revocable inter vivos trust. Of the total acreage, 1,108 were devoted to raising timber, 270 acres were rented for crop production under a cash rent lease and 100 acres were rented as pasture. After 1982, the timber operation on the 1,108 acres was carried on by the decedent's son. The son negotiated annual rental arrangements on the cropland and pasture land, periodically inspected the timberland, paid all property taxes and contracted to have the timber selectively cut at various times.

The Tax Court agreed with the taxpayer that the material participation requirement was met. The Court emphazied that the son — and the decedent before him — made all management decisions necessary for the operation of the timber business. The Court declared that it was irrelevant that the timber business did not consume all of their time.

The decision in *Sherrod,* when compared with *Coon* and *Schuneman, supra,* seems to reflect the view that what is required for material participation depends upon the nature of the business involved.

As to the effect of cash rented pasture and crop land, the court indicated that the 1,478 acre tract was a single, unified timber farming business operation. The fact that a relatively small part of the total was cash rented did not preclude a special use valuation election. The decision represents a *de minimus* test where land is cash rented incident to a farm business operation that is otherwise eligible. The case provides support for including cash rented pasture and hay land under a special use valuation election where the cash rented land is incidental to an otherwise qualified business operation.

It is important to note that pre-death cash rentals pose a problem only where the land is cash rented to a tenant who is not a member of the landowner's family.

— *Neil E. Harl*

Depletion of ground water

In 1965, after losing in court, IRS began allowing cost depletion to taxpayers in the Southern High Plains area for draw down in ground water. IRS now recognizes that ground water in areas of the Ogallala Formation in addition to the Southern High Plains, is being depleted. As a consequence, IRS has ruled (Rev. Rul. 82-214, I.R.B. 1982-50, 9) that cost depletion will be allowed elsewhere in the Ogallala Formation where it can be demonstrated that the ground water is being depleted and "that the rate of recharge is so low that, once extracted, the ground water would be lost to the taxpayer and immediately succeeding generations."

IRS points out that the income tax basis in the ground water must be adjusted for cost depletion deductions allowed. However, taxpayers in the Ogallala Formation outside the Southern High Plains area will not be required to reduce their basis in ground water by cost depletion that was allowable but not claimed for tax years ending before December 13, 1982.

— *Neil E. Harl*

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Some drainage systems ruled five year property for ACRS

IRS has ruled (Rev. Rul. 83-13, I.R.B. 1983-3, 6) that tile drainage systems and concrete ditches used to irrigate cultivated fields are five-year property for purposes of the Accelerated Cost Recovery System (ACRS). The IRS agrees that five-year property is Section 1245 property which is not three-year, ten-year or fifteen-year property. Essentially, property eligible for investment tax credit (with requirements paralleling those for Section 1245 property) is five-year property unless it has a present class life of four years or less. In the latter case, it is three-year property.

—*Neil E. Harl*

Disclaiming implied warranties of animal health

by Terence J. Centner

Prior to 1978, sellers of livestock in forty-nine states impliedly warranted that their animals were free from hidden or latent diseases. This occurred pursuant to each state's commercial law which was modeled after the Uniform Commercial Code. In the past eight years, twenty-four states have changed their laws so that sellers no longer impliedly warrant that their animals are disease-free. Unless a seller makes an express written or oral guarantee, a buyer of livestock assumes liability for latent diseases in the purchased animals under the revised laws of these states.

The legislative success of livestock sellers in securing statutory changes has not been accompanied by a showing that the shift of legal liability is economically advantageous. Of course if the Coase Theorem applied, the imposition of legal liability upon the buyer or seller would be immaterial except if there were transaction costs.[1] However, the nature of latent animal diseases suggests that the sale of livestock involves transaction costs. Indeed, the costs of the animal health guarantees constituted the impetus for sellers' intense efforts to reform their states' commercial law. Sellers wanted to shift liability to the buyers for health losses, including the difference in value between healthy animals and the animals sold and consequential damages incurred as a direct result of a latent disease.

The reallocation of liability for losses from latent animal diseases arguably does not shift equivalent sales costs because of the economics of information.[2] Sellers generally have better information concerning the health of their animals than buyers and are thereby in a better position to make the necessary economic expenditures to control latent diseases in animals being sold. Sellers' incentive to produce disease-free animals is diminished with the legislative abrogation of their liability for latent disease costs. Thus, the absence of an implied warranty of animal health means it is more difficult for buyers to learn about the quality of animals being purchased.

Livestock Warranties

Persons selling livestock are governed by the provisions of their state's commercial law unless they specifically provide otherwise. Since every state except Louisiana has adopted warranty provisions modeled after the Uniform Commercial Code, the general warranty provisions of the UCC provide a reasonably accurate account of the general warranty laws of forty-nine states. The warranty provisions provide guarantees that the product being sold will meet certain standards. A warranty thereby constitutes an agreement between the buyer and seller which governs the imposition of liability when the standards are breached.

The UCC prescribes four types of warranties that may constitute the basis for guaranteeing livestock health. Section 2-313 concerns express warranties made through an affirmation or promise, a description, or a sample that is part of the bargain. Livestock sellers may expressly warrant the health of their animals by describing the animals as disease-free, by stating that the animals are free from disease or from a clean herd, or by allowing the buyer to view a sample of the animals being purchased and stating that the other animals will be similar. The warranty created by a sample does not cover hidden or latent diseases because they would not be apparent in the sample.

Section 2-314 of the UCC concerns two types of implied warranties that are not dependent upon any oral or written agreement. The most important implied warranty is merchantability which is made in every contract for sale of goods by a merchant unless it is excluded or modified. The warranty guarantees that the goods will pass without objection in trade and are fit for the ordinary purposes for which they are used. Although there is some disagreement as to whether a farmer may be a merchant, it should be concluded that any farmer who regularly sells livestock impliedly guarantees as a merhcant that the animals being sold are suitable for the buyers' intended purposes. Diseases that would be visible to the buyer upon the transfer of the animals would not be part of this implied warranty because of the inspection exception.

The second implied warranty in section 2-314 applies to all sellers rather than only merchants and states that other implied warranties may arise from "course of dealing" or "usage of trade" unless excluded or modified. A "course of dealing" is a sequence of previous conduct between the same parties that establishes a common basis of understanding for interpreting their conduct. A "usage of trade" is any practice that is so regularly observed that it justifies an expectation that it will be observed with respect to the transaction in question.

A final type of warranty that a seller may make concerning the health of livestock is the warranty of fitness for particular purpose. Section 2-315 prescribes three elements for this warranty: (1) the seller must have reason to know that the buyer requires the goods for a particular purpose; (2) the seller must have reason to know that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods; and (3) the buyer must rely upon the seller's skill and judgment.

Removal of Warranties

The harsh consequences of a judicial decision in Nebraska, *Ruskamp v. Hog Builders, Inc.*,[3] provided the justification for the legislative removal of the implied disease warranty provisions in that state. A buyer of diseased hogs sued the sellers for a breach of an implied warranty that the hogs were fit for breeding purposes. The court agreed with the buyers and awarded them damages of $14,500 even though the sales price of the hogs was only $2,046.[4] Within two years of this decision the Nebraska Legislature amended its commercial code to provide that "with respect of the sale of cattle, hogs and sheep, there shall be no implied warranty that the cattle, hogs or sheep are free from disease."[5] This disclaimer removed the former implied warranty that cattle, hogs and sheep were free from latent diseases. Thereby, liability for losses arising from latent animal diseases has been shifted from the seller to the buyer.

The statutory exemptions enacted by other states accomplish a similar purpose but contain some significant distinctions. The most important distinction is whether other animals such as horses or poultry are included within the warranty exception. Another important distinction concerns additional qualifications which sellers must meet before the exemption frees them from liability for a breach of an implied warranty. A number of the state exemptions apply only if the seller did not knowingly sell animals which were diseased or sick. Sellers may also have to comply with state and federal regulations concerning animal health in order to qualify for the exemption.

Diminished Liability for Sellers

The statutory removal of some or all of the implied warranties of freedom from latent diseases which previously had accompanied the sale of livestock means that the seller is no longer liable for diseased animals except when the seller makes an express warranty. Sellers not making an express warranty thereby have no incentive to raise disease-free livestock. This may be expected to cause sellers to alter their business operations and to give less attention to methods, procedures and treatments to control the likelihood of latent diseases. The resulting less stringent disease control policies presumably will lead to the sale of greater numbers of diseased livestock.

The projected results of sellers would be expected to be accompanied by corresponding opposite results for buyers. The burden is on the buyer to guarantee the health of animals purchased, with several alternative options being available. Buyers may pay a premium and only buy livestock accompanied by an oral or written express warranty guaranteeing the animals' health. Another response by buyers may be to take out insurance to cover the risks that accompany unwarranted livestock. In the alternative, buyers may adopt methods, procedures and treatments to control the likelihood of disease. Finally, buyers may ignore the problem and do nothing thereby risking the chance of losses arising from the purchase of diseased livestock. In all of these cases the alternative options to the buyer involve increased costs for the buyer.

The projected results from the legislative removal of implied warranties for latent disease disclose lower costs for sellers and increased costs for buyers. In order to determine if either of these legislative allocations of liability is superior, the costs for sellers may be compared to the costs for buyers. The preferred legislation should minimize the costs that are incurred by both sellers and buyers to control latent disease in livestock.

Lack of Information

The removal of an implied warranty of animal health diminishes the information available to buyers concerning the health of the animals being purchased. The inability of buyers to differentiate between diseased animals and disease-free animals will preclude a price distinction between these classes of animals. Since buyers cannot opt to purchase the superior product, the lack of information on quality will lead to a deterioration in the quality of goods on the market.

An implied warranty provision tells buyers that there is a high probability that livestock being purchased are free from any latent disease. The payoff of this information is the expected value of the damages covered by the warranty and the expected value of information of the animals' health to the buyer.[6] The expected value of damages covered by an implied warranty of freedom from a latent disease is presumably modest. The probability of any damages is very low since relatively few animals are infected with a latent disease causing injury and losses. However, in the few cases where there exist animals with a disease, the losses may be great because of consequential damages. Thus, the expected value of damages covered by an implied warranty may be modest.

The expected value of the warranty information to the buyer is equivalent to the costs which a buyer would expend for disease prevention and control in the absence of a health guarantee. It is not clear what this value would be in the absence of information concerning the frequency of latent disease in animals. However, all of the previously noted alternative responses involve increased costs for the buyer.

Determination of Efficiency

An analysis of economic efficiency in the production of livestock through the allocation of costs arising from the sale of diseased animals commences with a determination of which party is best able to minimize these costs. Sellers have the advantage in this respect because they can take various precautions to assure that the animals are healthy prior to sale. Buyers of animals without an express warranty of animal health can vaccinate or treat the animals after purchase to avoid the costs which arise from diseased animals, but treatment expenses would probably be prohibitive. Thus, conditions in the livestock industry suggest that sellers have the advantage in minimizing disease costs.

An additional factor that impacts the allocation of liability for latent animal diseases is the existence of a legislative externalization of certain disease-related costs by state and federal laws. These laws dictate quarantine, vaccincation or disease testing requirements for slected animal disease and thereby may already allocate sales costs. The legislative removal of implied warranties for latent diseases in ten states has been accompanied by a requirement that sellers must meet all state and federal animal health regulations in order to qualify for the statutory exclusion. Thereby, the statutory disclaimer of implied warranties of these ten states is subservient to the policy decisions reflected in the existing regulations regarding selected animal diseases and adopts the relegation of liability as set forth by those regulations.

Conclusion

The legislative removal of implied warranties of animal health recently adopted by twenty-four states reduces the information available to buyers concerning the health of animals being purchased. The limited information available to buyers, as opposed to sellers, places them at a disadvantage in determining whether to make expenditures to reduce the possibility of incurring losses from diseased animals. Sellers have control over the exposure of the animals to sources or conditions which could cause a latent disease. Sellers are in a better position to determine the probabilities of the existence of a disease and to decide what remedial measures, if any, should be taken to guard against the risks of future losses arising from diseased animals.

These circumstances support a conclusion that the recent amendments to the implied warranty laws of twenty-four states to exempt latent livestock are inefficient; the legislative changes increase the costs of producing livestock. Unless there are clear policy considerations that favor the removal of sellers' liability for diseased livestock, the legislation set forth in the Uniform Commercial Code appears to offer a superior efficiency solution for the allocation of losses from latent diseases in livestock.

[1] Coase, "The Problem of Social Cost," 3 *J. Law Econ.* 1(1960).

[2] Stigler, "The Economics of Information," 69 *J. Pol. Economy* 213 (1961).

[3] 192 Neb. 168, 219 N.W.2d 750 (1974).

[4] 219 N.W.2d at 752.

[5] Nebraska Revised Statutes c. 91, ¶ 2-316.

[6] *See* Gerner and Bryant, "Appliance Warranties as a Market Signal?" 15 *J. Consumer Affairs* 75 (1981).

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Tax benefit rule

The U.S. Supreme Court, in its 1983 decision in *United States v. Bliss Dairy, Inc.*, resolved a major conflict among the circuits on application of the tax benefit rule. The major effect is expected to be felt in corporate liquidations which was the fact situation in *Bliss Dairy*.

In that case, the corporation, which operated a dairy, purchased cattle feed and, as a cash basis taxpayer, claimed the feed cost as an income tax deduction. Two days into the next taxable year, with a substantial part of the feed still on hand, the corporation adopted a plan of corporate liquidation under I.R.C. Section 333. No gain was recognized at the corporate level but the assets distributed in liquidation — including the purchased feed which by then had a zero income tax basis — received a new income tax basis derived from the basis of the shareholders' stock in the corporation. The basis in the feed then gave rise to a trade or business expense.

IRS, on audit, applied the tax benefit rule and required the value of the feed to be brought back into income. The U.S. District Court and the Ninth Court of Appeal, following the 1963 Ninth Circuit case of *Commissioner v. South Lake Farms, Inc.*, held for the taxpayer. The Supreme Court reversed, however, and ordered the corporation to include in income the portion of the cost of the feed attributable to the amount on hand at the time of liquidation.

The tax benefit rule, as generally applied, requires that a taxpayer report into income a benefit received that has previously been the subject of a deduction. The Supreme Court, explaining that the tax benefit rule should be applied on a case-by-case basis, stated:

> "The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax...and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule...Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will 'cancel out' an earlier decision only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction."

Quite clearly, those liquidating farm and ranch corporations on the cash method of accounting should give careful attention to inventories of feed, seed, fertilizer, chemicals and other inputs for which a deduction has been claimed. Since *Bliss Dairy*, those amounts will be includible in corporate income in the year of liquidation.

— *Neil E. Harl*

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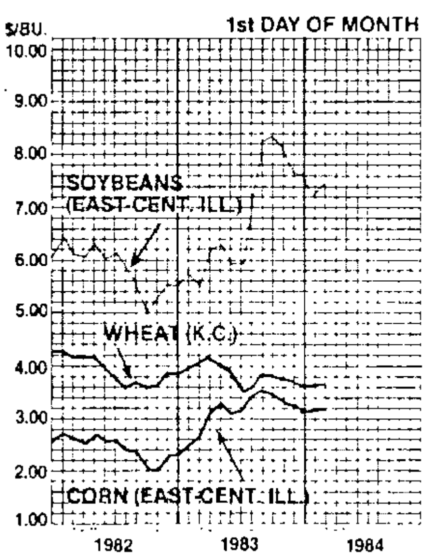

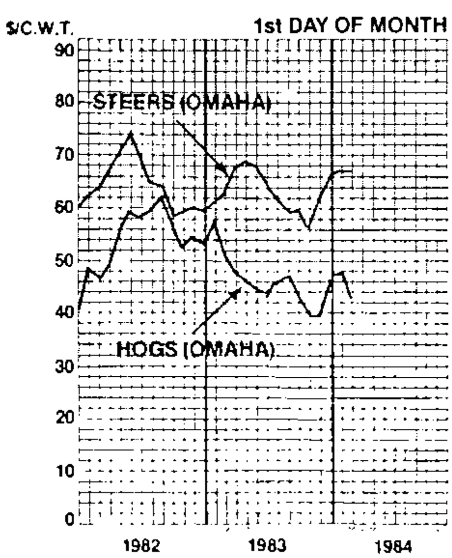

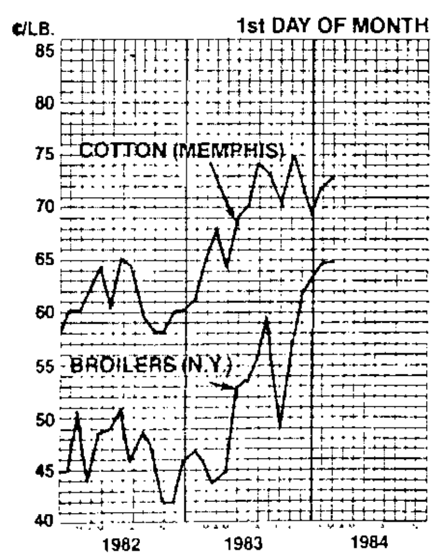

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AMERICAN AGRICULTURAL LAW ASSOCIATION NEWS

AALA Distinguished Service Award

The American Agricultural Law Association invites nominations for the "Distinguished Service Award." Any member of the Association may nominate another member for selection by submitting the name to the Chair of the Awards Committee. Nominations for this year must be made by May 1, 1984.

The Association is also sponsoring its first annual student writing competition. This year, the Association will award a cash prize in the amount of $750 to the author of the winning paper. The competition is open to all undergraduate, graduate or law students currently enrolled at any of the nation's colleges or law schools. Papers must be submitted to the Association by May 1, 1984.

Inquiries concerning both programs should be directed to: Professor David A. Myers, Chair, Awards Committee, American Agricultural Law Association, Valparaiso University School of Law, Valparaiso, Indiana 46383, (219) 464-5477.

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